2-1 What are the two types of personal financial statements? What is a budget, and how does it differ from personal financial statements? What role do these reports play in a financial plan?

*Personal financial statements* provide important information needed in the personal financial planning process. The balance sheet describes your financial condition [that is what assets and liabilities you have] at one point in time. The income and expense statement measures financial performance [cash surplus or deficit] over a given time period typically monthly or annually. Budgets help you plan your future spending. The budget is a statement of the future income or expenses that will result from your financial plan. By comparing the actual income and expenses to the budget you can see when your plan needs to be modified. Together these statements give you information needed for your financial planning process.

**2-2 Describe the balance sheet, its components, and how you would use it in personal financial planning. Differentiate between investments and real and personal property.**

Th*e balance sheet* summarizes your financial position by showing your assets (what you own listed at fair market value), your liabilities (what you owe), and your net worth (the difference between assets and liabilities) at a given point in time. With a balance sheet, you know whether your assets are greater than your liabilities, and by comparing balance sheets for different time periods, you can see whether your net worth is growing.

*Investments* are intangible assets that have market value [such as stock] and you hold in hpes of future increases in value and future income. *Real property* is an asset that is affixed to the ground, example is a house. *Personal property* is tangible property that is not real property, example is a car or furniture.

**2-3 What is the balance sheet equation? Explain when a family may be viewed as technically insolvent.**

The *balance sheet equation* is:

Net Worth = Total Assets - Total Liabilities

A family is *technically insolvent* when their net worth is less than zero. This indicates that the amount of their total liabilities is greater than the fair market value of their total assets.

**2-4 Explain two ways in which net worth could increase (or decrease) from one period to the next.**

There are basically two ways to achieve an *increase in net worth*. First, one could prepare a budget for the pending period to specifically provide for an increase in net worth by acquiring more assets and/or paying down debts. This is accomplished by planning and requires strict control of income and expenses. A second approach would be to forecast expected increases in the market value of certain assets—primarily investment and tangible property assets. If the market value of the assets increased as expected and liabilities remained constant or decreased, an increase in net worth would result. (Note: Decreases in net worth would result from the opposite strategies/occurrences.) Of course that is also the old fashion way, you inherit wealth.

**2-5 What is an income and expense statement? What role does it serve in personal financial planning?**

The *income and expense statement* captures the result of financial activities that you hoped would increase your wealth summarized for a month or a year. In personal financial planning, the statement permits comparison of actual results to the budgeted values to help you evaluate your financial plan.

**2-6 Explain what cash basis means in this statement: “An income and expense statement**

**should be prepared on a cash basis.” How and where are credit purchases shown when statements are prepared on a cash basis?**

The cash basis only records income that is received in cash or expenses that are paid in cash during the period. It ignores any amount that you are due [receivables] or that you will have to pay in the future [liabilities]. Payments on liabilities should be divided into payment of interest and payments on principle, but both are listed as expenses on a cash statement. Obviously the cash statement does not give a complete picture of a person income or expenses, but since most individuals do not have receivables and their liabilities are managed with monthly payments, the cash statement gives good information for financial planning.

**2-7 Distinguish between fixed and variable expenses, and give examples of each.**

*Fixed* expenses are contractual, predetermined expenses that are made each period, such as rent, mortgage and loan payments, or insurance premiums. *Variable* expenses change each period. These include food, utilities, charge card bills, and entertainment.

**2-8 Is it possible to have a cash deficit on an income and expense statement? If so, how?**

Yes, a *cash deficit* appears on an cash basis income and expense statement whenever the period's expenses exceed income. Deficit spending is made possible by using up an asset, such as taking money out of savings, selling an asset such as an investment, or incurring more debt, such as charging a purchase on a credit card.

**2-9 How can accurate records and control procedures be used to ensure the effectiveness of the personal financial planning process?**

Before you can set realistic goals, develop your financial plans, or effectively manage

your money, you must take stock of your current financial situation. Without accurate records, you do not have the needed information to make your financial decisions.

**2-10 Describe some of the areas or items you would consider when evaluating your balance sheet and income and expense statement. Cite several ratios that could help in this effort.**

Ratios are used to relate items from the financial statements. These ratios provide useful information for specific decisions. From the Balance sheet:

Current Ratio: Current Assets divided by Current Liabilities, useful for short term credit decisions

Solvency ratio: Total net worth divided by total assets; measures the degree of exposure to insolvency

Liquidity ratio: Total liquid assets divided by total current debts; measures the ability to pay current debts.

From the Income Statement:

Savings ratio: Cash surplus divided by income after taxes, indicates the portion of income you chose to save

Debt service ratio: Total monthly loan payments divided by Monthly gross (before tax) income, provides a measure of the ability to pay debts promptly

Return on Equity: Cash Surplus (a measure of net income) divided by New Worth, provides a measure of how well you managed your wealth.

**2-11 Describe the cash budget and its three parts. How does a budget deficit differ from a budget surplus?**

A *cash budget* is a summary of estimated cash income and cash expenses for a specific time period, typically a year. The three parts of the cash budget include: the *income* section where all expected income is listed; the *expense* section where expected expenses are listed by category; and the surplus or deficit section where the cash surplus or deficit is determined both on a month-by-month basis and on a cumulative basis throughout the year. A *budget deficit* occurs when the planned expenses for a period exceed the anticipated income in that same period. A *budget surplus* occurs when the income for the period exceeds its planned expenses.

**2-12 The Gonzales family has prepared their annual cash budget for 2016. They have divided it into 12 monthly budgets. Although only 1 monthly budget balances, they have managed to balance the overall budget for the year. What remedies are available to the Gonzales family for meeting the monthly budget deficits?**

Monthly deficits may be handled by shifting expenses to a later month or income to an earlier month. If that is not possible, the Gonzales family may withdraw an amount from savings or borrow a short-term loan to get the months in balance. Another alternative is to increase income perhaps with a second job or move to a higher paying job.

**2-13 Why is it important to analyze actual budget surpluses or deficits at the end of each month?**

By examining end-of-month budget balances, and the associated surpluses or deficits for all accounts, a person can initiate any required corrective actions to assure a balanced budget for the year. Surpluses are not problematic. Deficits normally require spending adjustments during subsequent months to bring the budget into balance by year end.

**2-14 Why is it important to use time value of money concepts in setting personal financial goals?**

A dollar today and a dollar in the future will be able to purchase different amounts of goods and services, because if you have a dollar today, you can invest it and it will grow to more than a dollar in the future. At the same time, inflation works against the dollar, because rising prices erode its purchasing power. *Time value of money* concepts help us quantify these changes in dollar values so that we can plan the amount of money needed at certain points in time in order to fulfill our personal financial goals.

**2-15 What is compounding? Explain the rule of 72.**

Interest is earned over a given period of time. When interest is compounded, this given period of time is broken into segments, such as months. Interest is then calculated one segment at a time, with the interest earned in one segment added back to become part of the principal for the next time segment. Thus, in *compounding*, your money earns interest on interest.

The *rule of 72* is a quick way to approximate how long it will take for an investment to double in value. Divide 72 by the percentage rate you are earning on your investment, and the answer will be approximately how many years it will take for your money to double. For example, if your investment is earning 8%, divide 72 by 8 to see that in approximately 9 years your money will double.

**2-16 When might you use future value? Present value? Give specific examples.**

*Future value* calculations show how much an amount will grow over a given time period. Future value is used to evaluate investments and to determine how much to save each year to accumulate a given future amount, such as the down payment on a house or for a child's college education. *Present value* concepts*,* the value today of an amount that will be received in the future, help you calculate how much a future cash receipt will be worth today, analyze investments, and determine loan payments.